CASE STUDY

Capitalization: Privatizing Bolivian Style

by José A. Valdez

Capitalization was conceived as an alternative to other methods of privatization to solve some of Bolivia's more acute economic problems. Like many other developing countries, these problems have persisted for decades: uneven distribution of income, inefficiency and corruption, growing deficits in state-owned companies, underdeveloped financial markets, and a low level of investment. To break this vicious circle of stagnation and underdevelopment, the government set as its goal to increase the investment rate to over 20% of GDP, which could only be accomplished by raising foreign investment.

The capitalization program has generated more than twice the amount of direct foreign investment in Bolivia than had been received over the previous fifteen years. Those investments have come into a diverse set of infrastructure sectors, including electricity, telecommunications, aviation, railways, and hydrocarbons.

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Moreover, the program has provided for social needs in the country by funneling investment into a broad pension program for the Bolivian people. Capitalization is helping to achieve accelerated development of Bolivia's productive capacity while also helping develop financial markets through the creation of privately managed pension funds.

The impact of this reform less than a year after its initiation is already evident to the general public. Investment flows into the capitalized sectors have improved, while the quality of services provided to low-income groups and isolated rural regions has risen. Bolivians now eligible to receive pensions are beginning to receive the benefits of privatized property through cash payments under the new pension system. These proceeds will gradually be received by the rest of the adult population over the next several decades, representing an unusual distribution of income associated with privatization reform.

Instituting a regulatory structure

A comprehensive regulatory system had to be created to protect investors and consumers. The Sectoral Regulation System (SIRESE) is composed of a general superintendency and five sectoral superintendencies for electricity, telecommunications, hydrocarbons, transport, and water services. The Financial Regulation System (SIREFI) is composed of a general superintendency and four sectoral superintendencies covering pensions, securities and exchange regulations, banking, and insurance sectors.

While the legal structure for these agencies is comprehensive, the superintendencies operate autonomously. General superintendents are appointed for a term of ten years and sectoral superintendents are appointed for a term of six years, and none can be reappointed immediately. Both types of superintendents are approved by congress and candidates must have a certain level of experience in their respective sectors. The activities of both regulatory systems are financed through collection of fees imposed on companies in regulated sectors.

Both regulatory structures set up a system of administrative courts. For example, complaints may be filed against the sectoral superintendencies and appealed to the general superintendent. Further appeals may be made through district courts and on up to the Supreme Court.

How capitalization works

The capitalization program differs from other privatization methods in several key respects. Its key elements are as follows:

- The government does not sell off the state-owned company but sets up "mixed capital corporations" (MCCs) to which a private partner contributes a 50% capital investment.
- The private partner's contribution stays in that MCC, increasing its value substantially.
- The MCC is transformed into a fully private company during this process, while the government's holding in the MCC is contributed to a pension program that provides annuity income to Bolivian citizens over the age of 65.

The selection is carried out in a simple three-step process:

Pre-selection Phase: The interested companies submit documentation that describes their technical, operating, financial and administrative capacity, in accordance with the requirements detailed in the terms of reference. This process is overseen by strategic advisors from private investment banks and specialized legal firms.

Bidding Phase: After qualifying under the criteria set out in the terms of reference, the pre-selected bidders are invited to submit their bids for purchasing the company's new share issue. The share package—equivalent to 50% of the capitalized company's capital—is awarded to the highest bidder. The award is made the same day the bids are submitted.

Closing phase: After completing all the necessary legal and administrative procedures, the amount that is put up by the winning bidder is paid into the accounts of the capitalized company, and the government's shares are transferred to a private pension manager to invest on behalf of the Bolivian people. Newly capitalized firms thus become 100% private with 50% of the shares in the hands of private investors, and the remaining 50% of the shares held in trust by pension fund managers mandated to pay benefits in cash to Bolivian citizens.

The entire process of selecting the strategic partner was carried out at public ceremonies broadcast live by radio and television, before notaries, domestic and international press, the company's workers, and the general public.


Photo: Felipe Sanguinés

Creating a sound pension program

The final step of the capitalization process is an important one for policymakers to manage because it helps to improve the public image of the privatization process and increase its social impact.

When the capitalization program was almost completed, the old pension pay-as-you-go system was converted to a program based on individual savings. With the new system, all Bolivians with a monthly income in excess of $50 can save for their retirement and have access to a more efficient and sound disability and death benefit system.

The new pension law created a two-tiered system of individual accounts: the Collective Capitalization Fund, formed with the government shares of capitalized companies; and the Individual Capitalization Fund, formed with contributions from participants in the new pension system. Both funds must be managed by private pension fund managers (AFP's—*Administradoras de Fondos de Pensiones*).

All Bolivians over the age of 21 as of December 31, 1995 (approximately 3.4 million people or 50% the of total population) are eligible to receive benefits from the government's share of newly capitalized companies. The Solidarity Bonus (BONOSOL)—worth approximately $250 a year—is paid to all Bolivians over the age of 65.

The AFP distributes the BONOSOL as an annual lifetime payment. As part of the Collective Capitalization Fund, funeral expenses are covered for citizens without any other form of insurance. Under the Individual Capitalization Fund, the AFP provides benefits for retirement, disability, death, funeral expenses, worker compensation, and other common risk insurance.

Workers can contribute at a minimum level to receive standard coverage, or may make additional voluntary contributions that increase their level of coverage.

Pension reform was completed at the beginning of 1997. After the approval of the new law, two Spanish consortia were selected as pension fund managers: Invesco-Argentaria and Banco Bilbao Vizcaya. The country was divided into two areas, north and the south, for each pension fund manager and a common operating area for both in the cities of La Paz, Cochabamba, Santa Cruz, and El Alto, which represent 57% of the population. All recipients were assigned one of the two fund managers. Four months after being selected, both pension fund managers began paying the BONOSOL to more than 350,000 Bolivians over 65 years old.

Engaging workers in the process

Because of the way the capitalization program is structured, managers were able to retain workers. With other privatization methods, companies need to regain the cost of purchasing the company, and often do so by reducing their labor costs. In Bolivia, these companies received an injection of capital that allowed them to make the necessary investments in brick and mortar, as well as in human capital, to become profitable quickly.

Furthermore, the program has given employees the chance to become partners in their own companies through the purchase of shares at preferential prices and conditions up to the limit of their social benefits. Under this program, workers are able to purchase a limited number of shares at the preferential rate for two years. Seventy-six percent of the workers in capitalized companies have chosen to purchase shares in this way and, as a result, have benefited from the rise in value of their holdings up to four times their original cost in the first year of their company's capitalization.

Bolivia's Capitalization Strategic Partners

- Dominion Energy (US)
- Energy Initiatives (US)
- Constellation Energy (US)
- STET International (Italy)
- Viacao Aérea Sao Paulo SA (VASP, Brazil)
- Empresa Cruz Blanca (Chile)
- Amoco Bolivia Petroleum Company (US)
- YPF-Pérez Companc-Pluspetrol Bolivia (US)
- Enron Transportadora-Shell Overseas Holding Ltd. (US)

How have the companies fared?

Between 1994 and 1997, five state companies were capitalized, representing the biggest companies in the Bolivian economy in the electricity, telecommunications, hydrocarbons, and transport sectors. (Companies in the electricity, hydrocarbons and railroad sectors were split into two or three units in order to prevent monopolies.) Today, almost all formerly state-owned Bolivian enterprises have either been capitalized or, if they were smaller companies, sold off by traditional privatization methods.

With capital contributions obtained from private investors, former state-owned companies increased their value from $706 million to just shy of $2.4 billion.

It is too soon to measure the full impact of capitalization on the Bolivian economy or the level of improvement it has created for the general population, but sector by sector some noticeable changes have been occurring.

Electricity: Before the capitalization program began, Bolivia was facing serious electricity shortages, especially during periods of peak demand during the winter. Now, two new thermoelectric plants in the regions of Cochabamba and Santa Cruz have been built by the capitalized companies and more new plants are being planned in the eastern section of the country.

Telecommunications: At the end of 1996, ENTEL, the newly capitalized telecommunications company, started the B-band cellular service, creating competition for local telephone systems around the country. User access fees dropped from more than $1,000 to $76. Another significant improvement in the sector was the increase in the number of public telephones available from 2,000 to 5,000 in the first two years after capitalization. This increase was especially beneficial to rural residents.

Railroad and Aviation: Companies in these two sectors were facing serious risks of insolvency in the short run; railroads generated losses of about $20 million per year, and the aviation company needed to replace at least two airplanes in order to continue operations. After the first year of capitalization, the airline was able to purchase one new airplane and lease two others, increasing the number of destinations and frequency of flights the airline could offer. The railroads—now split into two units—generated combined profits of almost $9 million during

The Seven Steps in Capitalization:

1 The book value of the company to be capitalized is determined in accordance with nationally and internationally accepted accounting and auditing standards.

2 The company is converted into one or more mixed capital corporations (MCC) with the participation of the government and the workers who accept the government's invitation to subscribe shares at book value.

3 The MCC increases its capital via a new share issue which is offered to potential private partners through international public bidding.

4 After a rigorous pre-selection system, the highest bidder is awarded the new shares, equivalent to 50% of the capitalized company's capital.

5 The successful bidder, after paying the cash amount of its bid, receives the share certificates and signs the share subscription contract and the administration contract.

6 The shares owned by the government are transferred to the pension fund managers.

7 The transfer of shares to the pension fund managers transforms the capitalized partnership into a corporation, managed by the private partner.

the first year of operation as private companies.

Hydrocarbons: The biggest natural gas project in South America is now being carried out with the participation of the Bolivian capitalized companies in the sector. For example, the Santa Cruz-Sao Paulo gas pipeline project—an estimated $2 billion investment—began at the end of last year and is expected to be finished before the year 2000. It is estimated that within the next six years the BONOSOL payment will be completely financed by profits from the three capitalized companies in the hydrocarbons sector.

When to capitalize

Capitalization is not a model for every situation. There are certain conditions and policy objectives that merit this approach as one component of an economic reform program. Some of those points are listed below:

❑ *Capitalize companies with a growing market for their products.* Capitalization is best suited to expand companies in growing markets for products or services. This situation applies mostly to infrastructure sectors in less developed countries where there are high levels of unmet demand by consumers.

❑ *Do not capitalize to pay government debts.* If debt payment is a major priority in a government's policy, then capitalization is a less attractive alternative because it does not generate cash resources for the government treasury.

❑ *Capitalization can help reverse strong public opinion against privatization.* Where the general population is opposed to privatization, the social welfare components of the program can help garner political support.

❑ *Countries with a poor distribution of income can benefit.* Pension components like the BONOSOL can help a government provide efficient ways of distributing income to low income groups. Although by international standards the amount of income provided by the bonus is small, in a country like Bolivia it represents a fourth of the annual per capita income for many people. The extra income will have a particularly strong impact on the poorest rural dwellers in the country.

❑ *Capitalization increases domestic savings.* State-owned companies tend to concentrate wealth in the hands of government bureaucrats. In the case of Bolivia more than 25% of GDP was locked up in state-owned enterprises. These holdings can be translated into savings if they are funneled into pension programs and managed privately.

❑ *Countries that need to reform their pension systems may get a boost from capitalization.* The transition from a pay-as-you-go system to a personal savings scheme normally involves high costs. A fund formed with shares of capitalized companies can help finance that transition cost.

❑ *Stronger financial markets can evolve from capitalization programs.* Countries with underdeveloped financial markets may be able to attract large companies as investors and private sector pension fund managers that they could not under other privatization methods. These investors and managers are necessary players in developing active financial markets.

❑ *Capitalization can improve a company's attractiveness to investors.* Investors are attracted to capitalization programs because they make a single investment into the new company rather than to government coffers. This outlay can be used to modernize and expand the company that is being purchased.

Capitalization is a new technique that needs to be studied as the Bolivian experiment unfolds. It will be an important part of the process for other countries to develop methods that are adapted to their own cultural settings. This process has already begun and will help strengthen capitalization as a viable means of privatizing.

How is the Program Faring?

The Bolivian capitalization program got off to a very good start. The transfer of state-owned enterprises to private sector management was handled professionally and was accompanied by a high degree of transparency. The pension program that was devised proved to be an ingenious way of cultivating popular support for the capitalization program. In particular, the voluntary contribution component of the new pension program (Seguro Social Obligatorio — SSO) is proving to be highly successful. According to Rosemary Werrett of the Latin American business biweekly *Lagniappe Letter*, the average pension received under the new privately managed system is $620 a month, compared to $200 under the previous government managed system. Employee contributions to this new system already exceeded $33 million as of last October.

Other components of the capitalization program have not fared as well. The biggest problem has been in maintaining the government commitment to the BONOSOL program. While the government commitment to providing annuity payments to pensioners rather than giving them shares probably prevented holdings from quickly becoming concentrated in a few hands, it also committed the BONOSOL fund to making $250 cash payments to pensioners each year. These payments were intended to be an obligation of the fund and thus would not require government outlays once the fund were launched.

However, according to Werrett, the current Hugo Banzer administration is claiming that its commitment to the program was based on figures provided by the previous government and that it has discovered several problems:

❑ The funds from capitalization should have been $1.674 billion, but fell $124 million short.

❑ The number of BONOSOL beneficiaries was underestimated by 21%.

❑ During the first year of operation, newly capitalized companies paid dividends of only $45 million on formerly government-owned shares, instead of the projected $130 million.

To make ends meet, the two pension funds administering BONOSOL sought a bank loan of $47 million to cover 1997 costs of $92 million. The BONOSOL fund also is empowered to sell shares in order to make up the shortfall in dividend revenue and to meet the promised annuity payments without government intervention. However, the fact that a stock market law has not yet been passed by the Bolivian congress has prevented registration of these shares for trading.

President Banzer is now trying to change the whole concept of the BONOSOL program by either abolishing or drastically reducing the BONOSOL payment program and redirecting its proceeds into infrastructure and economic development projects. At the very least, the government may institute limits or a moratorium on annuity payments for 1998. Government officials may encounter a public outcry, however, if they try to end a program that was slated to benefit the poorest in the country.